FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Ukraine at 'CC'

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Fitch Ratings - London - 23 Jun 2023: Fitch Ratings has affirmed Ukraine's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'CC'. Fitch typically does not assign Outlooks to sovereigns with a rating of 'CCC+' or below.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Foreign-Currency Debt Restructuring Probable: The affirmation of Ukraine's Long-Term Foreign-Currency IDR at 'CC' reflects Fitch's expectation of a further commercial debt restructuring before the two-year standstill on Eurobond payments expires in September 2024. The 24-month payment deferral effected in August 2022 constituted a distressed debt exchange (DDE) under Fitch's sovereign rating criteria. External sovereign debt service rises to USD7.6 billion in 2025, large fiscal deficits into the medium term will add to already high public debt, and burden sharing with commercial creditors is a likely condition of ongoing official sector support.

Specifics of Restructuring Still Unclear: The framework for Ukraine's four-year, USD15.6 billion IMF Extended Fund Facility (EFF) incorporates the commitment by The Group of Creditors for Ukraine to extend the official sector standstill to end-2026, with final debt treatment later in the programme once macro-uncertainty subsides, and the Ukrainian authorities' intention to seek comparability of treatment with commercial creditors. The authorities would likely prefer a single comprehensive debt restructuring next year, but if security-related uncertainty precludes this, we would still anticipate an intermediate step of further deferral on Eurobond payments, triggering another DDE.

'CCC-' Local-Currency IDRs Affirmed: The higher rating than foreign-currency debt reflects greater disincentives to restructure local-currency debt, given only 4% is held by non-residents, with 48% held by National Bank of Ukraine and 38% by the domestic banking sector, half of which is state-owned. We do not see significant international pressure to bring domestic debt into a restructuring, also due to risks to domestic demand for government debt and confidence in banks. Nevertheless, over a longer time horizon, there is still substantial credit risk given uncertainty over financing sources to fund a potentially protracted war, and a large recovery effort.

Protracted War: Fitch's base case is for the war to extend into 2024, within its current broad parameters. We consider Ukraine currently has the strategic military advantage, bolstered by upgraded weaponry, Western intelligence, and strong resolve. However, in our central scenario, there is insufficient military superiority to decisively deliver objectives. There also appears an absence of politically credible concessions that could form the basis of a negotiated settlement, potentially resulting in a very protracted conflict. Over a longer period, we expect some form of settlement to end the war, although see a frozen conflict as more likely than a sustainable peace deal.

Moderate Growth, Huge Reconstruction Costs: Fitch projects GDP grows 3.5% in 2023 and 4.0% in 2024, having contracted 29% in 2022. We assume some recovery in consumption on easing fears of broader military escalation, but still depressed investment. According to UN data, there are 6.3 million Ukrainian refugees, and a sizeable return represents an upside to our forecast. The World Bank estimates infrastructure damage at USD135 billion (84% of 2022 GDP), with reconstruction and recovery costs totalling USD411 billion. We anticipate under-execution of the planned USD14 billion of critical infrastructure spending this year.

Large Fiscal Deficits to Persist: The general government deficit widened by 12pp in 2022 to near 16% of GDP (25% of GDP excluding international grants) driven by military spending. Fitch projects a deficit of 17.3% of GDP in 2023 as a full-year of war-related expenditure and a reduction in the grant component of budget support offset moderate real-term cuts in recurrent social spending. We anticipate the deficit remains high into the medium term, partly given huge reconstruction needs, and structurally higher defence outlays than pre-war.

High and Rising Public Debt: The large deficit, and hryvnia devaluation drove a 30pp rise in general government debt/GDP in 2022 to 78.5% (71.6% excluding government guarantees), despite support from a GDP deflator of 34%. The foreign-currency share of state debt has risen to 69%, although there has also been an increase in concessional and longer-term debt. The war has led to higher risk of crystallisation of SOE contingent liabilities and government guarantees. Fitch forecasts debt rises to 85% of GDP at end-2023 and 94% at end-2024.

High Dependence on Official Financing: Committed budget aid support for 2023 totals USD43 billion and could increase with additional US finance in 4Q, up from USD32 billion in 2022. There is less detail on commitments for 2024 but Fitch assumes a broadly unchanged level, and the IMF EFF is underpinned by funding assurances from official creditors. Despite the EU's EUR50 billion funding proposal to 2027, we see greater financing uncertainty beyond next year, partly due to potential for donor fatigue.

Domestic Financing Conditions Improve: The rollover rate of government domestic debt has averaged more than 110% so far this year, up from 68% in 2022, partly due to a one-off boost from regulatory changes to bank reserve requirements. Fitch assumes a full-year rate of close to 100%, supported by strong liquidity in the Ukrainian banking sector, which was driven by 41% growth in deposits since the war started, boosted by military wages. This should be sufficient to prevent recourse to deficit financing from National Bank of Ukraine (which accounted for 42% of 2022 financing), although we see a greater risk to domestic funding from 2024.

Rise in International Reserves: FX reserves rose to USD37.3 billion in May, from USD28.5 billion at end-2022 (and a low of USD22.4 billion in July 2022) as strong international aid and stable remittances more than offset a large trade and services deficit. Spending by overseas migrants has recently edged down, and greater confidence in the exchange rate has slowed private sector capital outflows. Fitch projects the USD/UAH peg remains through 2023, with moderate depreciation in 2024 as greater exchange rate flexibility is introduced, and FX controls are relaxed only gradually.

Current Account Set to Widen: Fitch forecasts the current account deficit widens to a deficit of 1.8% of GDP in 2023 and 3.5% in 2024, from a surplus of 5% in 2022, as imports recover more quickly than exports. Large official sector loans and gradually improving net migration help underpin our projection for international reserves to increase to USD38.9 billion at end-2023, equivalent to 4.8 months of current external payments, above the median for all sovereigns rated in the 'B' category and below of three months.

Inflation Still High But Falling: Inflation fell to 15.3% at end-May (core inflation 15.6%) from 26.6% at end-December, on base effects, lower food and fuel prices, easing supply chain disruptions, and appreciation of the unofficial exchange rate. Fitch forecasts inflation falls to 14.5% at end-year, with a 5pp cut in the policy interest rate to 20%, but risks remain skewed to the upside, including the fallout from destruction of the Kakhovka dam. We project inflation averages 12.7% in 2024, still well above the peer group median of 6.2%.

ESG - Governance: Ukraine has an ESG Relevance Score (RS) of '5' for both political stability and rights and for the rule of law, institutional and regulatory quality and control of corruption. These scores reflect the high weight that the World Bank

Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model (SRM). Ukraine has a low WBGI ranking at the 32nd percentile, reflecting the Russian-Ukrainian conflict, weak institutional capacity, uneven application of the rule of law and a high level of corruption.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- The Long-Term Foreign-Currency IDR would be downgraded on signs that a renewed default-like process has begun, for example, a formal launch of a debt exchange proposal involving a material reduction in terms and taken to avoid a traditional payment default.

- The Long-Term Local-Currency IDR would be downgraded to 'CC' on increased signs of a probable default event, for example from severe liquidity stress and reduced capacity of the government to access financing, or to 'C' on announcement of restructuring plans that materially reduce the terms of local-currency debt to avoid a traditional payment default.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- The Long-Term Foreign-Currency IDR would be upgraded on de-escalation of conflict with Russia that markedly reduces vulnerabilities to Ukraine's external finances, fiscal position and macro-financial stability, reducing the probability of commercial debt restructuring.

- The Long-Term Local-Currency IDR would be upgraded on reduced risk of liquidity stress, potentially due to more predictable sources of official financing, greater confidence in the ability of the domestic market to roll over government debt, and/or lower expenditure needs.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Ukraine a score equivalent to a rating of 'CCC+' on the LTFC IDR scale. However, in accordance with its rating criteria, Fitch's sovereign rating committee has not utilised the SRM and QO to explain the ratings in this instance. Ratings of 'CCC+' and below are instead guided by Fitch's rating definitions.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Ukraine has an ESG Relevance Score of '5' for political stability and rights as WBGI have the highest weight in Fitch's SRM and are highly relevant to the rating and a key rating driver with a high weight. As Ukraine has a percentile below 50 for the respective governance indicator, this has a negative impact on the credit profile. The invasion by Russia and ongoing war severely compromises political stability and the security outlook.

Ukraine has an ESG Relevance Score of '5' for rule of law, institutional & regulatory quality and control of corruption as WBGI have the highest weight in Fitch's SRM and in the case of Ukraine weaken the business environment, investment and reform prospects; this is highly relevant to the rating and a key rating driver with high weight. As Ukraine has a percentile rank below 50 for the respective governance indicators, this has a negative impact on the credit profile.

Ukraine has an ESG Relevance Score of '4' for human rights and political freedoms as the voice and accountability pillar of the WBGI is relevant to the rating and a rating driver. As Ukraine has a percentile rank below 50 for the respective governance indicator, this has a negative impact on the credit profile.

Ukraine has an ESG Relevance Score of '5' for creditor rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Ukraine, as for all sovereigns. Given Ukraine's 2022 deferral of external debt payments which Fitch deemed as a distressed debt exchange, and that another DDE is probable in our view, this has a negative impact on the credit profile.

Ukraine has an ESG Relevance Score of '4' for international relations and trade, reflecting the detrimental impact of the conflict with Russia on international trade, which is relevant to the rating and a rating driver with a negative impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Ukraine	LT IDR	CC	Affirmed	CC
	ST IDR	C	Affirmed	C
	LC LT IDR	CCC-	Affirmed	CCC-
	LC ST IDR	C	Affirmed	C
	Country Ceiling	B-	Affirmed	B-
senior unsecured	LT	CCC-	Affirmed	CCC-
senior unsecured	LT	CC	Affirmed	CC

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Douglas Winslow
Senior Director
Primary Rating Analyst
+44 20 3530 1721
douglas.winslow@fitchratings.com
Fitch Ratings Ltd
30 North Colonnade, Canary Wharf London E14 5GN

Hannah Dimpker
Associate Director
Secondary Rating Analyst
+49 69 768076 263
hannah.dimpker@fitchratings.com

Shelly Shetty
Managing Director
Committee Chairperson
+1 212 908 0324
shelly.shetty@fitchratings.com

MEDIA CONTACTS

Peter Fitzpatrick
London
+44 20 3530 1103
peter.fitzpatrick@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 06 Apr 2023) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.3 (1)

Debt Dynamics Model, v1.3.2 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.13.3 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Ukraine	UK Issued, EU Endorsed

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